FX markets: Lowering your sights

FX markets have reacted to news of a much closer US election by selling currencies most exposed to the global recovery story and buying USD and JPY. Certainly, the prospect of at least smaller fiscal stimulus, if not an outright contested election – combined with poor Covid-19 trends – favour more defensive positioning this month

Election 2020, Tokyo, Japan - 04 Nov 2020

Source: Shutterstock

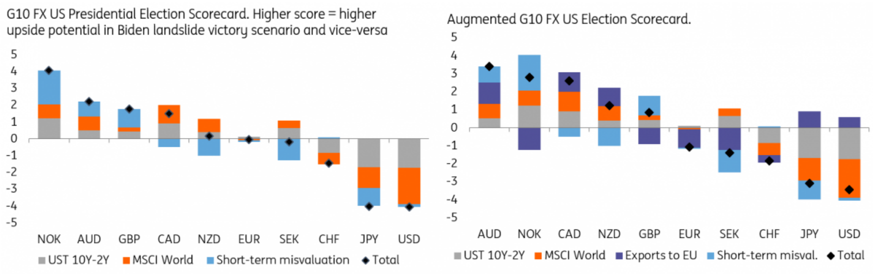
Scaling back the rally

FX markets went into the election priced for a Biden clean sweep. Large fiscal stimulus expected in January, a return to the rules-based trading system, and a Federal Reserve ready to run the economy hot had all contributed to the broad dollar decline and (helped by Covid trends in Asia) generated good demand for those currencies exposed to a rebound in global activity – or the reflation trade.

Instead, it looks very much like the Democrats will struggle to grab the Senate (suggesting a smaller fiscal stimulus as parties continue to bicker) and that whichever candidate secures 270 electoral college votes, that vote could well be challenged. A contested election looks a clear negative for risk assets, recalling the 8% decline in the S&P 500 back in November 2000 as the Supreme Court spent a month deliberating over a Florida recount.

We have been highlighting FX market sensitivities to the global recovery trade in articles such as the G10 FX Election Scorecard and these correlations have been holding up well. Further pressure on US equities and a flatter US yield curve would see Norway's krone and the Australian dollar as the most exposed, while the Japanese yen and US dollar should perform better during this uncertain environment. For choice, we would probably favour the JPY over the USD given the risk of a 'sell US' mentality emerging were the election result to be contested in the courts.

Which currencies are most exposed to the reflation trade/Biden clean sweep?



Source: ING

EUR: The headwinds are growing

Despite Europe heading into second wave lockdowns, EUR/USD had been holding up quite well. This was probably a function of the broad dollar decline – or effectively the global recovery story trumping the setback in Europe. After election night, the global recovery story is clearly providing less support now and instead, the European double-dip may play a greater role in EUR/USD pricing.

Here, the European Central Bank looks set to top up quantitative easing in December – a move the ECB sees as effective in keeping a lid on the euro. Until the US election result is clear, we suspect that EUR/USD trades in a 1.15-1.20 range – gyrating lower on prospects of a Trump presidency (more protectionism, targeting Europe?) and higher on a Biden presidency. Into 2021, however, we still lean towards a post-Covid global recovery trade coming through next summer. An ensuing broad-based dollar decline could still see EUR/USD trade up to 1.25 – but headwinds are growing to that call.

So far, emerging market currencies have actually held up a little better than expected. That may be because both the Fed and the ECB have light-trigger fingers when it comes to supplying fresh liquidity and that low core rates continue to favour a drive out along the credit curve into high yield, emerging market FX. We like this story in 2021, but again feel that an uncertain November – including the threat of renewed US lockdowns in December – favour patience when returning to the EM growth/yield investment theme.

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